

SUMMARY ANALYSIS OF AMENDED BILL

Franchise Tax Board

Author: Karnette Analyst: Colin Stevens Bill Number: SB 1788

Related Bills: See prior analysis Telephone: 845-3036 Amended Date: 5/18/98

Attorney: Doug Bramhall

Sponsor:

SUBJECT: Enhanced Oil Recovery Credit/Exclusion/Taxpayer Elect Which Applies

X DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced FEBRUARY 18, 1998.

X AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _____.

FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

X REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED FEBRUARY 18, 1998, STILL APPLIES.

OTHER - See comments below.

SUMMARY OF BILL

Under the Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), this bill would create an exclusion from income for the sale of oil or gas that is produced from a recovered inactive well, as defined, by a taxpayer who meets certain tests for claiming a depletion allowance. Taxpayers would be required to elect between claiming this exclusion and the existing state enhanced oil recovery (EOR) credit.

SUMMARY OF AMENDMENT

The May 18, 1998, amendment:

- Requires that a taxpayer elect on its original return either the EOR credit or the exclusion from income allowed by this bill, beginning with the year the recovered inactive well resumes production. Taxpayers who elect to claim the exclusion would be bound for five years and would not be eligible to claim the EOR credit until the sixth year after a recovered inactive well resumes production;
- Defines "sale" for purposes of the exclusion as a sale at the point of delivery from a recovered inactive well to any person that is not a related party;
- Limits the exclusion to producers who meet certain tests for claiming a depletion allowance under the Internal Revenue Code and who meet certain requirements to take the existing EOR credit;
- Removes existing election language in the EOR credit and inserts similar language that does not require that the taxpayer elect on a original return to claim the EOR credit or another credit; and
- Corrects an incorrect reference in the B&CTL to a PITL section.

Board Position:

<u> </u> S	<u> </u> NA	<u> </u> NP
<u> </u> SA	<u> </u> O	<u> </u> NAR
<u> </u> N	<u> </u> OUA	<u> X </u> PENDING

Department/Legislative Director

Date

Johnnie Lou Rosas

6/19/98

Other than the amendments described above, the addition of a policy and two technical concerns, the resolution of the policy concern regarding separate elections for each year, and the implementation and technical concerns, the department's analysis of the bill as introduced February 18, 1998, still applies.

Policy Considerations

Since the exclusion under this bill would be available for taxpayers for taxable or income years beginning on or after January 1, 1998, but only for the production of oil or gas that commences after January 1, 1999, this bill would in 1998 allow an exclusion to certain fiscal year filers that would not be allowed to calendar year filers for that same year, creating potentially inequitable treatment between fiscal and calendar year filers.

Technical Considerations

Although technically correct, language in the EOR binding taxpayers to either the EOR credit or the exclusion for a recovered well for the first five years after recovery of a well could be confusing to taxpayers. Amendments 1, 2, 3, and 4 would make clearer that a taxpayer who elects the exclusion from income added by this bill would be bound to that election for the first five years after the recovered inactive well resumes production. Conversely, if a taxpayer claims the EOR credit in the first year in which the recovered inactive well resumes production, the taxpayer would not thereafter be able to qualify to claim the exclusion from income.

The election language in the B&CTL EOR credit makes an incorrect reference to Section 17139.5, the PITL exclusion for a recovered inactive well. Amendment 3 would correct this error.

FISCAL IMPACT

Tax Revenue Estimate

Based on data and assumptions discussed below, this bill would result in revenue losses as shown in the table.

Estimated Revenue Impact of SB 1788 As Amended 5/18/98 [\$ In Millions]		
1998-99	1999-00	2000-01
minor loss	(\$1)	(\$1)

Minor loss is less than \$500,000. The bill would be effective with income/taxable years beginning on or after January 1, 1998. However, one condition for a "recovered inactive well" is that production of crude oil or natural gas from the well does not commence until after January 1, 1999. Losses would be largely under the B&CTL.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The revenue impact of this bill would be determined by (1) the number of idle wells that otherwise would return to production and under this bill also meet specified conditions to be "recovered inactive wells" for which eligible taxpayers elect to exclude any income from the sale of oil and gas, (2) the volume of oil and gas production from these wells, (3) the price per barrel, and (4) the potential offset of the Enhanced Oil Recovery (EOR) credit if any of the same wells are EOR projects. (Independent producers are eligible for the EOR credit for EOR projects.)

In California, the Department of Conservation, Division of Oil and Gas (DOG) has responsibility for regulating idle oil and gas wells. Based on information furnished by DOG, idle wells in California as of late 1997 totaled approximately 19,400. DOG estimates that independent producers hold about 30% of idle wells. DOG categorizes inactive wells by period of inactivity as follows:

Number of Inactive Wells In California as of Late-1997 By Number of Years Inactive			
<u>5-10 Yrs</u>	<u>10-15 Yrs</u>	<u>15 Yrs +</u>	<u>Total</u>
8,841	5,516	5,020	19,377

A relatively small percentage of idle wells return to production. The longer a well remains idle, the less likely it will return to production. Returning to production a well that has been inactive for a period of years requires an investment of several thousand dollars.

Industry contacts suggest incremental oil and gas production from recovered inactive wells by all producers is not likely to reach even 1% of average barrels per day production. In California, average barrels per day of crude oil production are roughly 950,000. Production moves up or down relative to the price per barrel. The current per barrel price is \$8.25. The average price usually ranges from \$12 to \$13.50 per barrel.

Assuming (1) incremental oil and gas production from recovered inactive wells by all producers is 0.75% of average barrels per day production in California, (2) about 30% of this production is from recovered inactive wells held by independent producers, (3) an average per barrel price of \$12, and (4) a tax rate of 8.84% would result in a revenue loss of \$800,000 as a result of the exclusion. Based on industry contacts, an insignificant effect was assumed for a projected loss of foregone EOR credits by independent producers. (The tax expenditure estimate for total EOR credits is on the order of \$2 million annually.) The assumed insignificant offset for the EOR credit is based on information gathered from a number of industry sources, which indicate that only a small portion of wells returned to production would also be wells using qualified EOR. Most EOR projects in California are long established and date back to the early 1970s. These projects are ineligible for the EOR credit. Because enhanced recovery is capital intensive, generally it is only the larger independents that have sufficient capital to use these methods. In addition, some types of enhanced recovery methods do not qualify for the federal and state EOR tax

credits, and wells using enhanced oil recovery generally are kept producing until exhaustion to maximize oil recovery for the associated expense of using enhanced recovery methods.

BOARD POSITION

Pending.

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 1788
As Amended May 18, 1998

AMENDMENT 1

Strike from "Any" on page 3, line 32 to page 4, line 2, inclusive and insert:

If a taxpayer elects to claim the exclusion from income for a recovered inactive well under Section 17139.5, then the exclusion allowed under Section 17139.5 shall apply to the first five consecutive taxable years beginning with the taxable year in which the recovered inactive well resumes production, and the taxpayer shall not be allowed to claim this credit until the sixth taxable year following the year in which the recovered inactive well resumes production. Any credit allowed after a taxpayer has claimed an exclusion under Section 17139.5 shall be allowed only for those expenses attributable to costs paid or incurred on or after the sixth year following the year the recovered well resumes production.

AMENDMENT 2

On page 5, strike from "Any" on line 16 to "section." on line 19.

AMENDMENT 3

On page 7, line 11, strike "17139.5" and insert:

24326.5

AMENDMENT 4

On page 7, strike from "Any" on line 15 to Line 24, inclusive and insert:

If a taxpayer elects to claim the exclusion from income for a recovered inactive well under Section 24326.5, then the exclusion allowed under Section 24326.5 shall apply to the first five consecutive income years beginning with the income year in which the recovered inactive well resumes production, and the taxpayer shall not be allowed to claim this credit until the sixth income year following the year in which the recovered inactive well resumes production. Any credit allowed after a taxpayer has claimed an exclusion under Section 24326.5 shall be

allowed only for those expenses attributable to costs paid or incurred on or after the sixth year following the year the recovered well resumes production.

AMENDMENT 5

Strike from "Any" on page 8, line 38 to "section." on line 19 of page 9.